FUNDING A BUY/SELL AGREEMENT

Many business owners realize that it is important to plan for their individual financial future, but they don't spend as much time considering their business's future. What will happen if you want to retire and sell your business? Have you established a plan by which your partners can buy you out? Or, if something happens to you, will your family be able to sell your practice to cover other expenses? Not having a plan of this kind can have a detrimental effect on your business, your partners, your family, and your own financial situation.

Creating a buy/sell agreement can mitigate the potential problems you and your family may face in the event of your retirement or death. A buy/sell agreement is an arrangement between you and a prospective buyer of your business. It's an important step in business succession planning because it gives your family a guaranteed buyer for your business at an agreed-upon purchase price, while providing the buyer with the necessary funds to carry out the agreement.

The sale may be triggered by your death, disability, or retirement. In the case of your death, for example, the buyer is required to buy your business. A funding analysis today can help you plan for the most efficient transfer for both your estate and the buyer.

The funding methods should be established at the time you execute the buy/sell agreement. You should also periodically review these methods to ensure that the agreement is keeping up with inflation and your business's growth.

When you analyze the best methods for funding a buy/sell agreement, you need to consider interest and opportunity costs, as well as any legal and setup fees. Interest includes the cost of borrowing at any time. The general interest rate levels affect the cost and attractiveness of borrowing. Your business incurs opportunity costs when you can't access money held in a sinking fund for investing in the business. Cash held in a sinking fund may cause the company to miss out on a more profitable business investment or an expansion opportunity. Legal and setup fees increase with the funding method's complexity.

The ideal funding method must take into account the transfer's anticipated time frame. Often, the time frame is unknown, as death or disability can happen at any time. For this reason, insurance on the business owner's life traditionally funds a buy sell/agreement. Life and disability insurance proceeds are then available when they are needed most. Premiums used to buy life and disability insurance to fund the buy/sell agreement are not deductible. But the proceeds are generally received income tax-free.

If your business has more than one owner, differences in the age, health, ownership amounts, and income of the business owners can affect the choice of funding. It is not unusual for the largest stockholder to be the oldest owner and the most highly paid. If the agreement requires the younger owners to buy out the majority stockholder, or vice versa, the discrepancy in insurance premiums can be burdensome to the younger, lower paid owners. Creative solutions are needed to even out the paying field.

Continued >

Funding a Buy/Sell Agreement continued

When insurance is not feasible, other options, each with pros and cons, exist. These include funding with cash, borrowing, installment payments, private annuities, sale-leasebacks, appreciated property bailouts, and deferred compensation. Often, the buyer will resort to a combination of methods.

Here are the various funding methods with their advantages and disadvantages:

Funding Method	Advantages	Disadvantages
Lump-sum cash	Seller gets money up front.	Buyer may not have enough cash.
Private annuity	These are used in family transfers to lower seller's estate value.	Seller is an unsecured creditor.
Borrowings	Seller gets money up front.	Buyer may not be able to obtain credit.
Installment payments	Gain can be spread over time; seller's interest is secured.	Buyer's inexperience may cause the business to fail before payoff.
Sale-leaseback	Seller gets money up front.	There is no guarantee.
Section 303 stock redemption	Seller receives cash for estate expenses.	Local law may restrict redemption of stock in an undercapitalized business.
Deferred compensation	Seller receives payments beginning at retirement.	Buyer's inexperience may cause the business to fail before payoff.
Appreciated property bailout	Seller receives asset in exchange for stock.	Seller does not receive cash.
Life insurance	Seller gets money up front.	Seller may be uninsurable.
Disability insurance	Seller receives lump sum and/or installments after disability.	Seller may be uninsurable.

Planning for your business's future is a fundamental component of planning for your family's financial future. A buy/sell agreement may be the best way to protect your business and your family. We will work with you to determine if this arrangement is right for your business and which funding method best suits your financial situation.

Commonwealth Financial Network® does not offer tax or legal advice. You should consult a tax or legal professional regarding your individual situation.